RECENT DEVELOPMENTS IN THE FEDERAL FARM LOAN SYSTEM

The decision[1] of the Supreme Court of the United States on February 28, 1921, sustaining the constitutionality of the Federal Farm Loan act came as no surprise to those who were familiar with the more subtle provisions in the act and the points involved in the litigation. In framing the original measure Congress had taken pains to insure its constitutionality. It had empowered the Secretary of the Treasury to designate any land bank, federal or joint-stock, as a depositary of public money, except receipts from customs, and as a financial agent of the government; it had empowered both federal and joint-stock land banks to buy and sell United States bonds; and, lest there be some question about the constitutionality of exempting the bonds of these banks from all taxation, especially state taxes, it had declared all first mortgages executed to land banks and all farm loan bonds to be "instrumentalities of the government of the United States." These safeguards effectively accomplished the purpose for which they were intended because the Supreme Court in its decision adhered closely to time honored precedents.

The case first got into the hands of the courts in July, 1919, when Charles E. Smith, a stockholder in the Kansas City Title and Trust Company, instituted proceedings in the United States District Court at Kansas City, Missouri, to enjoin the trust company from investing funds to the amount of $10,000 in bonds of the federal land banks, and $10,000 in bonds of the joint-stock land banks. It was the contention of Smith, among other things, that although farm loan bonds purported to be tax exempt, Congress had exceeded its constitutional authority in providing for the creation of federal and joint-stock land banks with the power to issue tax-exempt bonds; and that therefore these bonds were improper securities for the investment of trust company funds.

The Federal Land Bank of Wichita and certain joint-stock land banks intervened in the suit. The case was heard on October 29 and 30, 1919, and at the conclusion of the hearing the trial judge upheld the constitutionality of the act and dismissed the bill of complaint. From this decision, Smith immediately appealed to the United States Supreme Court where the case was argued January 6, 1920, and again on October 14 and 15 by Ex-Justice Hughes and Ex-Attorney General

[1] *Charles E. Smith* v. *Kansas City Title & Trust Company et al.* Justice Brandeis took no part in the consideration of the case. Justices McReynolds and Holmes in dissenting from the majority opinion took exception to the court's assumption of jurisdiction rather than to the findings themselves.

Wickersham on behalf of the banks and by Messrs. Marshall Bullitt and Frank Hagerman on behalf of the complainant. In its conclusions the court expressed its conviction that "the contention of the government and of the appellees that these banks are constitutionally organized and the securities here involved legally exempted from taxation must be sustained."

A review of the numerous briefs submitted by counsel for appellant shows that the case against the farm loan act was based upon three contentions as follows:

1. That Congress has no power under the Constitution, either expressed or implied, to create a corporation for the purpose of conducting a farm-mortgage loan business.

2. That Congress could not acquire power to create a series of corporations to engage in this business or to exempt them from all state control by the mere expedient of calling them "banks" and endowing them with the possible function of acting as financial agents or depositaries of public money.

3. That in view of the unconstitutionality of the act, the tax exemption clause cannot be sustained.

It can hardly be said that the above contentions were adhered to rigidly throughout the entire course of the litigation proceedings. On the contrary, there was a good deal of diversity, at least on the matter of emphasis, in the method of attack that was followed. In the earlier hearings, the case against the government was based chiefly on the contention that Congress had no power under the Constitution to create land banks or to appropriate public money for the purpose. In the final brief, submitted upon re-argument, counsel for the appellant seemed partly to admit the power of Congress to appropriate money for the creation of the land banks and to exempt their bonds from federal taxes. They contended, however, that these bonds are at least subject to state taxation, and that, after all, "tax exemption is the real issue sought to be settled here."

In support of the contention that Congress has no power to create federal and joint-stock land banks, it was pointed out that the decisions of the Supreme Court in *McCulloch* v. *Maryland*,[2] etc., afford no basis for the creation of land banks; that the implied power of Congress to incorporate a bank under article 1, section 8, clause 18 of the Constitution was based upon the ground that in order to carry out the express powers to collect taxes, to borrow money, to regulate commerce, to carry on war and to raise and support armies and navies, it was absolutely necessary for the government to conduct fiscal operations; and that the corporations created under the farm loan act were not

[2] 4 Wheat, 316.

intended "as a machine for the fiscal operations of the government," nor were they designed to engage in a commercial banking business. On the contrary they (especially the joint-stock banks) were intended primarily as private profit-making institutions and were non-essential to the performance of any governmental function.

The position taken by Ex-justice Hughes on this point on behalf of the federal land banks was that the agricultural interests of the country are of public national concern and relate directly to general welfare; that Congress has the power to appropriate the public money to such purposes; that the machinery created by the farm loan act was intended to stimulate the cultivation of the soil and to promote agricultural development; and that Congress could therefore appropriate money and lend it to farmers at low interest rates. It was argued by Ex-attorney General Wickersham, representing the joint-stock land banks, that in creating corporations to engage in the business of making farm loans, Congress had merely exercised its power to establish agencies to perform necessary and essential governmental functions.

In deciding this point, on which the other issues involved were really dependent, the court by Justice Day said:

> Since the decision of the great cases of *McCulloch* v. *Maryland,* 4 Wheaton 316, and *Osborn* v. *Bank,* 9 Wheaton 738, it is no longer an open question that Congress may establish banks for national purposes, only a small part of the capital of which is held by the Government, and a majority of the ownership in which is represented by shares of capital stock privately owned and held; the principal business of such banks being private banking conducted with the usual methods of such business.

In answer to the contention that land banks are not comparable in function to the commercial banks which Congress has from time to time authorized and which have been held to be within the power of Congress to authorize, the court held that:

> A bank may be organized with or without the authority to issue currency. It may be authorized to receive deposits in only a limited way. Speaking generally, a bank is a moneyed institution to facilitate the borrowing, lending and caring for money.

And by way of justifying reasonable liberality in construing the implied powers of Congress, the court referred to the decision in *First National Bank* v. *Union Trust Company*[3] where, after reviewing *McCulloch* v. *Maryland* and *Osborn* v. *Bank,* the chief justice, speaking for the court, said:

> In terms it was pointed out that this broad authority was not stereotyped as of any particular time but endured, thus furnishing a perpetual and living sanction to the legislative authority within the limits of a just discretion enabling it to take into consideration the changing wants and demands of

[3] 244 U. S. 416, 419.

society and to adopt provisions appropriate to meet every situation which it was deemed required to be provided for.

The opinion of the court as above quoted touches also upon the second contention of the appellant, namely, that it was not the purpose of Congress to provide agencies which were intended to perform essential and necessary governmental functions, and that section 6 of the act providing that the Secretary of the Treasury might designate any of the federal or joint-stock land banks as depositaries of public money and financial agents of the government was merely a device to make valid what would otherwise be unconstitutional.

There can be no question but that section 6 of the act was a subterfuge. While the bill was pending in Congress, Senator Hollis and other friends of the measure had such grave doubts as to its constitutionality that they openly admitted the necessity of endowing the proposed land banks with some governmental function however unnecessary and incidental to the main operations this function might be. Senator Hollis, for instance, made the following statement on the floor of the Senate:

> The constitutional features of the bill have given me great concern. . . . If any friend of the bill can think of any other feature that should be added to it to make the bill surely constitutional, I would very gladly welcome it.[4]

Responding to the call for help, Senator Cummins later made the significant statement:

> In this case, however, the chief purpose of the corporation, as avowed by all who have spoken on its behalf and as I think will be admitted by everybody, is to secure a lower rate of interest to those who borrow from the land banks; that is its only object. It is necessary, however, to find some governmental purpose, however slight or insignificant, in order to invoke the authority of Congress in the incorporation, and, therefore, it is declared that these land banks shall be public depositaries, . . .[5]

Not only is it true that the land banks were not intended by Congress to become necessary governmental agencies, but there is also the fact that these banks have not been designated as government depositaries or financial agents, except that during the summer of 1918 the federal land banks at Wichita, St. Paul, and Spokane were temporarily designated as financial agents of the government for the sole purpose of making seed grain loans to drought-stricken farmers.[6] No joint-stock land bank, however, has ever been used even temporarily for this purpose.

It is possible that the court felt constrained to consider carefully

[4] *Congressional Record*, vol. 53, p. 7026.

[5] *Ibid.*, p. 7246.

[6] For details see *Annual Report of the Secretary of the Treasury, 1919*, pp. 139-144.

the fact that in section 6 Congress had deliberately maneuvered to safeguard the constitutionality of the act and thereby to accomplish the real purpose it had in mind, namely, to reduce the rate of interest to farmers. But the issue is clearly disposed of in the decision. Referring again to the decision in *McCulloch* v. *Maryland* which involved, among other things, the right of Congress to establish the Second Bank of the United States, the court said:

> That the formation of the bank was required in the judgment of the Congress for the fiscal operations of the Government, was a principal consideration upon which Chief Justice Marshall rested the authority to create the bank; and for that purpose being an appropriate measure in the judgment of the Congress, it was held not to be within the authority of the court to question the conclusion reached by the legislative branch of the Government.

And again:

> The existence of the power under the Constitution is not determined by the extent of the exercise of the authority conferred upon it. Congress declared it necessary to create these fiscal agencies, and to make them authorized depositaries of public money. Its power to do so is no longer open to question.
>
> But, it is urged, the attempt to create these Federal agencies, and to make these banks fiscal agents and public depositaries of the Government, is but a pretext. But nothing is better settled by the decisions of this court than that when Congress acts within the limits of its constitutional authority, it is not the province of the judicial branch of the Government to question its motives.

In sustaining, *in toto*, the power of Congress to establish land banks which, though incidental to their main function, *might* be employed as public depositaries and financial agents of the government, the contention of counsel for the appellant that the exemption of farm loan bonds from federal taxation could not be sustained, naturally fell to the ground. In this connection the court said:

> Deciding as we do, that these institutions have been created by Congress within the exercise of its legitimate authority, we think the power to make the securities here involved tax exempt necessarily follows. This principle was settled in *McCulloch* v. *Maryland,* and *Osborn* v. *Bank, supra.*

There remained only the argument that even though farm loan bonds were legally exempt from federal taxes, they would still be subject to state taxation because they were not real or essential instrumentalities of the federal government. To hold otherwise, it was argued, would permit Congress to encroach little by little upon the taxing power of the states merely by designating taxable objects as "instrumentalities of the government of the United States" until there would remain nothing for the states to tax and they would be destroyed on account of their inability to raise revenue.

Without attempting to deal specifically with the logic in this argument, the court quoted Chief Justice Marshall's famous "power to "destroy" doctrine[7] as laid down in *McCulloch* v. *Maryland* and held that:

> The exercise of such taxing power by the states might be so used as to hamper and destroy the exercise of authority conferred by Congress, and this justifies the exemption. If the states can tax these bonds they may destroy the means provided for obtaining the necessary funds for the future operation of the banks.

And the court added significantly, "With the wisdom and policy of this legislation we have nothing to do."

The fundamental reason for this litigation together with the results that have followed and may be expected to follow will now be noted.

It is no secret that although one Smith was the original complainant in what was purely a test case, it was at the instance of the farm mortgage bankers that proceedings were instituted. They were the ones who were vitally interested in having the farm loan act declared invalid, especially that provision in the law exempting farm loan bonds from taxation. For good cause they feared the competition of the federal land banks less than that of the joint-stock banks, and it was therefore against the latter that their attack was concentrated throughout the litigation proceedings.

That the joint-stock land banks promised to be the more dangerous competitors is shown by the record of their progress. Up to November 30, 1918, nine joint-stock banks had been organized. Their paid-in capital amounted to $2,010,850 and the volume of their loans was $7,289,870 or less than 5 per cent of the total volume of loans outstanding under the entire system. By July of the following year, when proceedings were instituted, twenty-one joint-stock banks had been organized with a total paid-up capital of $5,308,000. On November 30, 1919, there were thirty joint-stock banks in existence with a paid-up capital of $8,638,650 and total outstanding loans of $54,126,357, or more than 16 per cent of the volume of loans granted under the entire system.[8]

Even more striking has been the rate of progress of the joint-stock banks when the results for particular months are noted. During November, 1918, the loans made by these banks amounted to 15 per cent of the total for the entire system. During the corresponding month of 1919, their loans represented 38 per cent of the business of the

[7] For a review and criticism of this doctrine as now applied see the writer's article "Investment Securities and Tax Exemption," Washington University Studies, vol. VII, Humanistic Series, no. 1, 1919, pp. 6-14.

[8] Data from *Third Annual Report of the Federal Farm Loan Board,* 1919, pp. 3-4.

system for that month. So rapid was their progress during the year 1919 that the Federal Farm Loan Board expected them to transact over 40 per cent of the total land bank business for the period November 1, 1919 to May 1, 1920.[9]

But it was not alone the actual and potential growth in the business of the joint-stock banks that aroused the antagonism of the farm mortgage bankers. Of even greater importance was the fact that these banks, unlike the federal land banks, confined their operations chiefly to the more highly developed agricultural sections of the country which were already served by the old line mortgage agencies. Of the twenty-one banks, for instance, which had been organized before July, 1919, nine were chartered to do business in Iowa (and in all cases one other contiguous state), five in Minnesota, three in Illinois, and three in Nebraska,[10] etc. There can be no question but that the joint-stock banks found their most profitable field for operation in the states which rank first in agricultural development, and that the growth in the volume of their business was largely at the expense of the farm mortgage companies rather than the federal land banks. Under these conditions, it was but natural that the farm mortgage bankers should attack the constitutionality of the farm loan act, especially that section of the law exempting farm loan bonds from taxation.

But if tax exemption gave the joint-stock banks any substantial advantage over the farm mortgage companies, why did not the latter reorganize their business under a federal charter and secure the same privileges?

The reason for their hesitancy in joining the system was twofold. In the first place they had attempted as early as October, 1917, to secure certain changes in the law which would enable them to come into the system as federal corporations and to operate on terms of equality with federal land banks without prejudicing their earning

[9] *Ibid.* One reason for the greater rate of progress shown by the joint-stock banks is the fact that they make larger individual loans. Up to November 30, 1919, the average size of loans made by these banks was $9,308, while the amount loaned by the federal land banks on the same date represented an average of $2,637 per loan. There is a legal limit of $10,000 to the size of individual loans that federal land banks may make, and no legal limit to the amount that joint-stock banks may lend to individual borrowers. In the exercise of its general supervisory powers, however, the Farm Loan Board has ruled that a joint-stock bank may not make a loan to any one borrower in excess of 15 per cent of its capital stock, nor in any case in excess of $50,000. (*Third Annual Report,* 1919, p. 4.)

[10] For full details as to name and location of joint-stock banks and the states in which they are authorized to operate, see *Hearings before the Committee on Banking and Currency of the House of Representatives on H. R. 8159, 66 Cong., 1 Sess.,* p. 27.

power or methods of doing business during the experimental stage of their existence. The changes[11] which they proposed in the law were entirely reasonable and in keeping with the place that private enterprise should occupy in the farm loan system. But their proposals failed to receive the endorsement of the Federal Farm Loan Board, and the matter got no further.

In the second place, largely as a result of the numerous conferences that were held between a special committee of the Farm Mortgage Bankers Association and the Federal Farm Loan Board, there developed a feeling that the board was hostile toward those sections of the law pertaining to joint-stock land banks, and it was generally concluded that these institutions would not be accorded fair treatment in the system.

However much there may have been at the time to warrant this feeling, subsequent events seem to have justified the premonitions of the farm mortgage bankers. The board is now none too friendly toward the joint-stock banks. It has viewed with some concern their remarkable progress due to their "ability to sell a standard form of tax free security";[12] the Secretary of the Treasury has definitely recommended the withdrawal of the tax exemption privilege from all their future bond issues;[13] and the board has not only endorsed a bill introduced in the Senate to accomplish this purpose, but has also stated its conviction that "the federal land banks can fully serve all those classes of farm borrowers who are within the reasonable purview of the act."[14] This statement, made while the constitutionality of the farm loan act was being considered by the Supreme Court, was prompted ostensibly by the fear that in view of the rapid increase in the number of joint-stock banks, the growth in the volume of their business, and the condition of the investment market, it might become impossible to dispose of farm loan bonds in sufficient quantities to keep both federal and joint-stock land banks in operation.[15]

The fears of the board lest the federal land banks be obliged to discontinue their operations were realized, but for a totally different reason. The institution of proceedings by the farm mortgage bankers seriously affected the operations of the whole system—a cloud was

[11] Enumerated by the writer in "The Federal Farm Loan System," American Economic Review, vol. IX, no. 1 (March, 1919), p. 73.

[12] *Third Annual Report,* pp. 3-4.

[13] *Annual Report of the Secretary of the Treasury, 1920,* p. 188.

[14] For details see letter of Geo. W. Norris, Farm Loan Commissioner to George B. McLean, Chairman, Senate Committee on Banking and Currency, Feb. 17, 1920. Reprinted by Farm Mortgage Bankers Association of America as Special Bulletin No. 62.

[15] *Ibid.*

cast upon the validity of farm loan bonds which made them virtually unmarketable. Fortunately, at the conclusion of the Victory Loan campaign in the spring of 1919, bonds had been offered and sold in sufficient quantities to carry the banks to January, 1920; and in anticipation of an early decision by the Supreme Court, some of the banks used their commercial credit and continued lending operations till February. By March 1, 1920, however, their funds were entirely exhausted, and thereafter they remained practically inactive.[16]

Believing that the emergency called for public intervention, Congress passed a House joint resolution May 26, 1920, authorizing the Treasury to purchase a limited amount of federal land bank bonds to be secured only by mortgages approved before March 1. The rate on the bonds was raised from 4 ½ to 5 per cent. On December 31, 1920, the Treasury had purchased bonds to the amount of $45,400,000 thereby enabling the federal land banks to take care of the greater portion of their definite commitments up to March 1 of that year, and to liquidate their short-time paper.[17]

The joint-stock banks received no aid from the national treasury during the litigation period, yet in the fourteen months, October 31, 1919, to December 31, 1920, the number of banks increased from 25 to 30 and the volume of loans outstanding from $48,092,816 to $77,958,642. During the same period the number of national farm loan associations increased from 3,862 to 3,966 and the volume of federal land bank loans from $271,317,816 to $349,678,987.[18] Not only was the rate of progress of the joint-stock banks much greater than that of their competitors, but they transacted over 28 per cent of the new business of the farm loan system during the fourteen months period. The year 1920 ended, however, with only twenty-seven joint-stock banks in existence, three of the newly organized banks having gone into liquidation under an amendment to the farm loan act approved May 29, 1920, wherein provision was made for the voluntary liquidation of these banks and for the acquisition of their assets and the assumption of their liabilities by the federal land banks.[19]

Notwithstanding the fact that the validity of farm loan bonds has been established, there is still some question as to whether the land banks will be able immediately to function. With a view to securing approximate uniformity and a material reduction in interest rates

[16] *The Commercial and Financial Chronicle,* vol. 112, no. 2905 (Feb. 26, 1921), p. 792.

[17] *Annual Report of the Secretary of the Treasury, 1920,* p. 187; also *House Doc. No. 998, 66 Cong., 3 Sess.,* p. 2.

[18] *Annual Report of the Secretary of the Treasury, 1919,* pp. 1085-1091; also *House Doc. No. 998, 66 Cong., 3 Sess.,* pp. 3-5.

[19] For details see *Annual Report of the Secretary of the Treasury, 1920,* p. 186.

throughout the country, the farm loan act fixed the maximum rate that might be paid on bonds at 5 per cent, and the highest rate including commissions that might be paid by borrowers at 6 per cent. With 5 per cent bonds of the federal land banks selling in the open market below par, and with a flood of applications for loans, it is difficult to see how either the federal or joint-stock land banks can meet the farm loan needs of the country without an amendment to the act raising the maximum interest charges allowed, or permitting the sale of 5 per cent bonds below par.[20] In any case, it is hardly to be expected that the problem will be easily solved for the joint-stock banks because, even if some liberality were allowed in the rates that could be paid to bondholders, there is less likelihood that the Farm Loan Board would recommend an increase in the maximum rate that farmers might pay on loans.

There is another and even more serious problem confronting the joint-stock banks. While the Supreme Court has settled the constitutionality of their right under the present law to issue tax-exempt bonds, there is reason to believe that attempts will be made, as in the past,[21] to amend the law so as to deprive these banks of the tax exemption privilege. Action of this kind would readily meet with the approval of the Farm Loan Board—assuming that the tax exemption privilege was still retained for the federal land banks—and would probably be defended on the ground that "tax exemptions in the case of joint-stock land banks amount to a gift at the expense of the government and the taxpayers generally and should not be continued with respect to these private-mortgage companies organized for private profit."[22] If this point could once be gained, further attempts[23] would doubtless be made, in accordance with the suggestions of Ex-secretary

[20] It might be that the board would so construe its powers as to permit the sale of 5 per cent bonds below par. Section 20 of the Federal Farm Loan act having to do with the form of farm loan bonds says merely that "they shall bear a rate of interest not to exceed five per centum per annum."

[21] A bill was introduced in Congress (S. 3109, 66 Cong., 2 Sess.) Sept. 30, 1919, by Senator Smoot providing for the repeal of the tax exemption privilege on future bond issues of the joint-stock banks. It is worth noting that while the bill was under consideration by the Senate Committee on Banking and Currency, representations were made to the committee that the joint-stock banks "are likely to encroach upon the legitimate field now occupied by the farm-loan banks unless their activities are restricted." (Calendar No. 270, Senate Report No. 317, 66 Cong., 2 Sess.)

[22] *Annual Report of the Secretary of the Treasury, 1920,* p. 189.

[23] H. R. 8159 (66 Cong. 1 Sess.) provided for an increase in the maximum amount that a federal land bank might lend to a single borrower from $10,000 to $25,000. This was in accordance with a recommendation made by the Farm Loan Board in its *First Annual Report* and renewed in the *Second Annual Report.*

of the Treasury Houston, to enlarge the powers of the federal land banks and permit them to make any loan now authorized by joint-stock banks so that "there would be no curtailment of the financial benefits to agriculture provided by the act."[24]

Manifestly, the status of the joint-stock banks is unsettled and insecure. Unless they find a friend in the new administration it is doubtful whether they will be able to hold their own in the farm loan system. It is certain, at least, that if the policies which have been recommended to date were carried out, many of these institutions would be compelled to go into "voluntary" liquidation and few new banks would be established, because they would have the greatest difficulty in competing with the federal land banks so long as the latter were allowed to make large individual loans and to issue tax-exempt bonds. It remains to be seen just what attitude the new administration will take toward these proposals.

It is unfortunate for the joint-stock banks, and for sound public policy as well, that the constitutionality of exempting farm loan bonds from federal taxes has been sustained. At most, the joint-stock banks can derive but a temporary benefit from tax exemption—in view of the needs of the national Treasury and the demand for an equitable distribution of the tax burden—while for political reasons it may prove to be exceedingly difficult to withdraw the tax exemption privilege from bonds of the federal land banks. It should be noted, however, that (1) no valid argument can be advanced to support the policy of exempting the bonds of federal land banks from taxation which does not also apply to bonds of the joint-stock banks, and that (2) the evils[25] of tax exemption in a system of progressive taxation are so great that under no circumstances should the bonds of either type of bank be exempt from federal income taxes. General recognition of these fundamentals would not only be a desirable step in the direction of tax reform, but would also remove once and for all the opportunity to use the tax weapon as a means of discriminating against the joint-stock banks, and would strengthen materially the position of private enterprise in the farm loan system.

GEORGE E. PUTNAM.

Chicago, Illinois.

[24] *Annual Report of the Secretary of the Treasury, 1920,* p. 189.

[25] For a discussion of the arguments for and against tax exemption see the writer's article "Investment Securities and Tax Exemption," Washington University Studies, vol. VII, Humanistic Series, no. 1, 1919, pp. 3-29.